IN THE

Supreme Court of the United States

October Term, 1947

No. 365

EDWARD R. DOWNING, suing on his own behalf and on behalf of all other stockholders of THE UNITED CORPORATION (of Delaware), etc.,

Petitioner,

against

GEORGE H. HOWARD, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE DEFENDANTS THORNE AND OTHERS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

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Opinions Below.

The opinion of the Circuit Court of Appeals (R., following p. 152a) is reported in 162 F. (2d) 654. The opinion of the District Court (R. p. 126a) is reported in 68 F. Supp. 6.

Jurisdiction.

Jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended (28 U. S. C. 347). The judgment of the Circuit Court of Appeals was entered June 24, 1947. The petition for a writ of certiorari was filed September 23, 1947.

Statement of the Case.

Plaintiff, a minority stockholder of The United Corporation, brought a derivative action against that corporation and numerous officers and directors, by filing a complaint in the United States District Court, District of Delaware, on August 10, 1944, and thereafter, a year or more later, serving the defendants with process in Massachusetts, Connecticut, New York and Pennsylvania (R. 3a-8a), three of the twenty-six defendants only having been served in the State of Delaware.

Jurisdiction of the Federal Court was invoked solely on the alleged ground that this action was authorized by Section 25 of the Public Utility Holding Company Act (15 U. S. C. 79(y)). The defendants on whose behalf this brief is submitted moved to dismiss the complaint under defenses (1) to (5) of Rule 12(b) of the Federal Rules of Civil Procedure. The District Court granted the motions to dismiss, on the ground that the Court lacked jurisdiction over the subject matter of the action (R. 132a-136a). The Court stated in its opinion that in view of its determination as to the lack of jurisdiction, a determination with respect to the other grounds of the motion, such as venue, became unnecessary (R. 136a). The Circuit Court of Appeals for the Third Circuit affirmed this determination, also stating that

it had become unnecessary to pass on the other grounds of the motion (162 F. (2d) at p. 659).

The defendants in this minority stockholder's suit are the directors, former directors of United and certain banking firms which are alleged to have controlled the directors and to have conspired with them. The amount claimed from the defendants jointly and severally is more than $100,000,000. The gist of the complaint is that the defendant directors and officers caused The United Corporation to retain the stocks of subsidiary companies and to vote in favor of the consolidation of subsidiary companies while United continued to remain unregistered under the Public Utility Holding Company Act, and after the registration of the company caused it for three years to fail to submit a proper plan of reorganization and divestment to the Securities and Exchange Commission. It is alleged that defendant directors and officers did this acting "in furtherance of a fraudulent conspiracy to waste and dissipate the assets of United" and for the wrongful purpose of profiting at United's expense and of benefiting the banking firms named as defendants (R. 32a, 43a, 55a, 56a). It is alleged that during the period of non-registration the market value of the securities owned by United depreciated by about $87,000,000 (R. 31a, 36a). It is not claimed that if the company had registered on December 1, 1935 this loss would have been prevented. It is not claimed that if the company had registered it would not have continued to own the securiites in question.

The period during which United failed to register and during which the market value of its securities declined was the period between the effective date of the registration provisions of the Public Utility Holding Company Act, December 1, 1935, and the date of the decision of this Court upholding the constitutionality of those provisions,

March 28, 1938 (*Electric Bond & Share Co.* v. *S. E. C.*, 303 U. S. 419). On that day United registered (R. 29a).*

Both the District Court and the Circuit Court of Appeals have held that the case at bar is not one to enforce a "liability or duty created by" the Public Utility Holding Company Act. The Circuit Court of Appeals emphasized that this was not such an action because the injury of which the petitioner complains did not result from any violation of the Act. It pointed out that the violation of the Act on which plaintiff relies was the holding and voting of the stock in question while the company was unregistered. It went on to hold that since the same loss would have occurred if the company had registered, the injury to United did not result from any violation of the Act, but from other causes, chief among which was the decline in the market value of the securities during that period (162 F. (2d) at p. 658). As the District Court said, this case is just "the traditional minority stockholders' suit for waste and dissipation of assets through breach of common law fiduciary duties" (R. 136a).

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* In this connection we quote from the memorandum filed by the Securities and Exchange Commission as *amicus curiae* in the case at bar in the Court below, to which petitioner makes reference in his petition herein:

> "Immediately after the adoption of the Holding Company Act scores of injunction suits were instituted in courts throughout the country, and the *Bond and Share* proceeding was selected by the Government as an appropriate vehicle for a test case. In official and public statements issued at the time, the Commission, the Attorney General and the Postmaster General disclaimed any intention, unless and until the constitutionality of the Act was sustained by the Supreme Court, to enforce the civil or criminal penalties of the Act or to close the mails to violators, or thereafter to seek penalties for earlier offenses. These statements were incorporated into the stipulation of facts entered into as a basis for the trial in the *Bond and Share* case."

Petitioner concedes in his petition to this Court for a writ of certiorari that the service of process on the undersigned defendants was not effective and the case not properly cognizable by the Federal court unless this is an action to enforce a *liability or duty created* by the Public Utility Holding Company Act, as provided in Section 25 of the Act (Petition, p. 2).

Statutes Involved.

Section 25 of the Public Utility Holding Company Act of 1935 (15 U. S. C., Section 79y) provides:

> "Jurisdiction of offenses and suits
>
> "The District Courts of the United States, the Supreme Court of the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this chapter or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law *brought to enforce any liability or duty created by,* or to enjoin any violation of, this chapter or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this chapter or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. * * * "

Other statutes to which reference will be made herein are Sections 4 and 11e of the same Act (15 U. S. C., Section

79d and 15 U. S. C., Section 79k(e)). These statutes are reprinted in full in the appendix to petitioner's brief at pages 43-8.

The Question Presented.

Is this a suit in equity "to enforce any liability or duty created by * * * " the Public Utility Holding Company Act of 1935, within the meaning of Section 25 of that Act, so as to confer jurisdiction of this case upon the United States District Court for the District of Delaware?

Argument.

The complaint fails to set forth any claim to enforce any liability or duty created by the Public Utility Holding Company Act. This case does not involve, nor did the Circuit Court of Appeals decide, any important questions relating to the interpretation of Sections 4a, 4b and 11e of the Act. This case solely involves the application of time-honored principles of the law of causation and of the fiduciary obligations of corporate directors. The decision of the Court below is not in conflict with the decision of the Second Circuit Court of Appeals in *Goldstein* v. *Groesbeck* (142 F. (2d) 422, cert. den. 323 U. S. 737). The Federal Courts have no jurisdiction over this case.

POINT I.

The Circuit Court did not deny the existence of the right of a private party to enforce Sections 4 or 11(e) of the Public Utility Holding Company Act but its decision is confined to a holding that the case at bar is not an action to enforce any liability or duty created by that Act.

The general theory of the complaint is that the defendant directors failed to act with an eye single to the interests of United and engaged in a fraudulent conspiracy to dissipate and waste its assets and to profit certain outside interests in breach of their fiduciary duties (R. 32a-34a, 43a, 55a, 56a). Taking these allegations as true, the defendants would be liable under the time-honored rules governing the conduct of corporate fiduciaries. *Pepper* v. *Litton*, 308 U. S. 295; *Southern Pacific Co.* v. *Bogert*, 250 U. S. 483. Obviously, the Federal courts have no jurisdiction over such a cause of action in the absence of diversity of citizenship.

The only basis of Federal jurisdiction asserted here is that this is an action brought to enforce a liability or duty created by the Public Utility Holding Company Act. Petitioner argues that because that Act makes it unlawful for a holding company to own and vote shares of subsidiaries unless registered, it is such an action. He argues further that the question for this Court to decide is whether an individual stockholder has the right to bring an action for violation of these provisions, and claims that the Circuit Court of Appeals denied the existence of such a right.

We think it is clear that the Circuit Court did not pass on this question, and that it is not involved in the case.

The Circuit Court said (162 F. (2d) at p. 658, 659):

> "We are unwilling to take the position urged by the defendants that the violation of the registration provisions of the statute will never bring about individual liability. Violation has been held liability creating in one situation." (Referring to *Goldstein* v. *Groesbeck*, 142 F. (2d) 422; cert. den. 323 U. S. 737.) "It may or may not be in others. This case is decided on a narrower ground."
>
> * * * * * * * * *
>
> "Our conclusion is, with regard to plaintiff's first and second claimed causes of action, that we need not commit ourselves on the question whether violation of registration requirements may in some circumstances be made the foundation of assertion of private rights. We shall answer that question when a case compels us to do so. It is sufficient to say that such circumstances are not here presented by the plaintiff. We think that here, even if the violation of the statute could be made the basis of recovery, this plaintiff has not, even when we take all his allegations as true, brought himself into the area of recovery. We do not see how the Corporation's and therefore shareholders', loss through depreciation of securities or their exchange has been tied into the failure to register. The only possible basis for federal court jurisdiction is under a cause of action 'created' by the Public Utility Holding Company Act of 1935. We think plaintiff, although he has presented his case with great skill, has failed to show any legal connection between the violation of the Act and the loss."

We shall not enter, therefore, into an academic discussion with petitioner as to whether a private party may enforce the registration provisions of the Act under given circumstances.

Petitioner suggests that the application by the Court below of well established principles of causation amounted to a novel interpretation of the Act—namely, an interpretation limiting liability to cases where the violation caused the damage complained of (Pet's. Br., pp. 24-30). That has been the law from time immemorial, and the decisions of this Court so hold. *St. Louis & San Francisco Railroad Company* v. *Conarty*, 238 U. S. 243 (1915); *Lang* v. *New York Central Railroad Company*, 255 U. S. 455 (1921); *Davis* v. *Wolfe*, 263 U. S. 239 (1923).

It will be noted that petitioner has not cited in his brief a single case in which a court, by holding or by dictum, suggests that a violator of a statute is liable for damage irrespective of the cause of such loss.

No doubt *Texas & Pacific Railway* v. *Rigsby*, 241 U. S. 33 (1916) held that where a member of a class for whose benefit a statute was enacted, is damaged, a right of action exists in the damaged party whether or not such right is specifically spelled out in the statute. It is equally clear, however, as this Court has held in discussing the Safety Appliance Act cases, of which the *Rigsby* case is one, that the plaintiff can only recover by establishing that the statutory violation was the proximate cause of the injury. *Davis* v. *Wolfe*, 263 U. S. 239 (1923). There this Court stated the rule as follows (p. 243):

> "The rule clearly deducible from these four cases is that, on the one hand, an employee cannot recover under the Safety Appliance Act if the failure to comply with its requirements is not a proximate cause of the accident which results in his injury, but merely creates an incidental condition or situation in which the accident, otherwise caused, results in such injury; * * *"

Professor Beale has aptly summarized the applicable rule in *The Proximate Consequences of an Act*, 33 Harvard Law Review, pages 633, 637, as follows:

> "Where the act is the failure merely of a legal duty, causation is established only when the doing of the act would have prevented the result; if the result would have happened just as it did whether the alleged actor had done his duty or not the failure to perform the duty was not a factor in the result, or in other words, did not cause it."

In holding that the damage and the profits claimed by the plaintiff in this complaint in the first two causes of action did not result from a violation of this statute, the Circuit Court of Appeals was clearly correct. The illegal act of which the plaintiff complains was the holding and voting of these securities *when the company was not registered*. The lack of registration was the illegal aspect of defendants' act, and not the mere holding and voting of the securities. If the company had registered, it would have been entirely legal and proper for it to hold the securities. There is no allegation in the complaint that if United had registered it would have been required to dispose of the securities or forbidden to vote or exchange them or that the same loss would not have occurred.

Plaintiff argues in his brief that if the defendants had not caused United to continue to own the securities of its subsidiaries, it would not have suffered the loss in the value of those securities. The statute did not make it an offense to hold and vote these securities. The statute merely made it an offense to hold and vote them if the company were unregistered. The qualification of "unless registered" is the essence of the offense. Without it there is no offense. For the plaintiff to bring himself within the Act, therefore, he must show that it was the holding and

voting of the securities, combined with the lack of registration, which caused the damage and resulted in the profit.

We concede that one of the purposes of the Act was to protect the interests of investors in the securities of holding companies, but this protection was to be procured by the requirement of registration, not by the requirement that companies should dispose of all their securities unless registered. This becomes clear when we consider what would have happened if United had been required to sell all the securities in question—of a value of nearly $200,000,000—between the time the Act went into effect on August 26, 1935 and December 1, 1935 when it was required to register. The dumping of these securities within that short period would have had a disastrous effect on their value and market price, and far from being in the interests of investors of United, would have been calamitous. It must be kept in mind that the Act provides that after December 1, 1935, the selling of securities by an unregistered holding company is just as unlawful as the owning or voting of such securities (Section 4(a)(3)). Therefore, plaintiff can complain only of the failure to sell the securities prior to December 1, 1935. There is no affirmative requirement in the Act forcing any public utility holding company to divest itself of its securities prior to that date.

This Court itself has taken pains to point out that even the death sentence provision (Sec. 11(b)) of the Public Utility Holding Company Act "does not contemplate or require the dumping or forced liquidation of securities on the market for cash." *North American Co.* v. *S. E. C.*, 327 U. S. 686, 709. Section 11 of the Act itself which provides for the ultimate dismemberment of certain holding companies, also provides that they shall not be required to divest themselves of the stock of their subsidiaries until after January 1, 1938 and even after that date a grace period of

one year was given under Sec. 11(c). From this it must be apparent that the prohibition against the holding of securities if the company failed to register had the purpose of protecting investors only by tending to enforce registration and not by forcing the immediate sale of the securities. In *Electric Bond & Share Co.* v. *S. E. C.*, 303 U. S. 419 (1938), the Court clearly indicated that Sec. 4(a) was enacted to enforce registration by prohibiting the interstate activities of unregistered companies within the purview of the Act. The Court in that case, at page 442, recognized that these provisions were in the nature of penalties to ensure compliance with the registration provisions of the Act.* The plaintiff can complain, therefore, only if the loss is the result of the failure to register.

What has been said with respect to the proximate cause of the loss in the value of the securities applies equally to the profits allegedly made by the defendants. The complaint is wholly devoid of any allegation to the effect that had the company registered these profits would not have been made. If the company had registered it could have given its underwriting business to any banker of its choice. The most that petitioner can say is that there would have been no "assurance" of these profits because the Securities and Exchange Commission might have disapproved or modified certain transactions. That leaves the question of the connection between the statutory violation and the alleged loss entirely to conjecture and speculation. See: *Tennant* v. *Peoria & P. U. Ry. Co.*, 321 U. S. 29, 32-3 (1944); *A. T. & S. F. Ry. Co.* v. *Toops*, 281 U. S. 351, 354-5 (1930); *New York Central R. R. Co.* v. *Ambrose*, 280 U. S. 486, 489-

* In both the Senate and House Reports (S 621 74th Cong. 1st Session p. 25; H. R. 1318 74th Cong. 1st Session p. 11) the following language occurs: "This section (4(a)) establishes the mechanism by which holding companies are brought under the jurisdiction of the Commission so that the provisions of title I may be effectively administered."

90 (1930); *C. M. & St. P. Ry.* v. *Coogan*, 271 U. S. 472, 478 (1926).

Similarly, the complaint does not allege in the second cause of action that the consolidation complained of and the exchange of the stock pursuant thereto would not have taken place in just the same way if the company had registered. Petitioner's speculations about what the Securities and Exchange Commission might or might not have done if United had been registered will not supply proximate cause.

The third cause of action alleges in substance that the defendants failed to submit to the Securities & Exchange Commission a plan for the reorganization of United and that this was done under the domination and control of the defendant banking groups and in breach of the fiduciary duties of the defendant directors to the detriment of United and for the benefit of said banking groups (R. 55a, 56a). The Public Utility Holding Company Act, however, does not require the submission of any such plan, as was pointed out by the Court below (162 F. (2d) at p. 656). The Act is purely permissive providing that such a plan "may" be submitted (Sec. 11(e), 15 U. S. C. 79k(e)). The complaint charges that the defendants were running United as an "economically unnecessary" holding company (Pet.'s Br., p. 39), in order to make it possible for the banking groups to profit from the banking and investment business of United. If the defendants did not run United with an eye single to the interests of that corporation, they may well have been guilty of a breach of their common law fiduciary obligations. By failing to submit a plan under Section 11(e), however, they did not violate any provisions of the Act, and, therefore, the third cause of action is not one to enforce any liability or duty created by that Act. *Commonwealth & Southern Corp.* v. *S. E. C.*, 134 F. (2d) 747, 751 (C. C. A. 3rd); *American Power & Light Co.* v. *S. E. C.*, 329 U. S. 90, 114-5, 119.

POINT II.

There is no conflict between the decision of the Circuit Court in the case at bar and that of the Circuit Court of Appeals for the Second Circuit in *Goldstein* v. *Groesbeck*, 142 F. (2d) 422, cert. den. 323 U. S. 737.

The only conflict among the Circuits which petitioner claims in respect of the decision below has to do with the decision of the Court of Appeals for the Second Circuit in *Goldstein* v. *Groesbeck*, 142 F. (2d) 422, cert. den. 323 U. S. 737, although petitioner admits that the opinion of the Third Circuit "did not express any disagreement with the decision in that case" (Pet. p. 13). The claim of a conflict, in other words, is inferential only. It is said that "the bases of the decision are in conflict". However, an analysis of the *Goldstein* case will show that this is not so. The Third Circuit expressly referred to that case, as shown in the quotation at page 8 above, in support of the statement that violation of the registration provisions of the Act might in certain situations bring about liability. The Third Circuit, however, was correct in going on to hold in the present situation that a stockholder suing corporate directors for causing a corporation to violate Section 4(a) must not only show the existence of the violation, but also that the damage was proximately caused thereby and directly traceable to the breach. These elements were present in the *Goldstein* case.

In the *Goldstein* case, the plaintiff, a stockholder of American Light & Power Co., an intermediate subsidiary of Electric Bond & Share Company, sued to recover back fees which had been paid by American's operating subsidiaries to Bond & Share's service company subsidiaries, pur-

suant to contracts made with Bond & Share, an unregistered holding company. Judge CLARK held that the action was "surely to enforce a duty created by the Act, since but for the Act the payments under the service and construction contracts would be innocuous enough" (142 F. (2d) at p. 425).

Section 26 of the Public Utility Holding Company Act (15 U. S. C. § 79(z)) provides that any contracts made in violation of the provisions of the Act are void. Electric Bond & Share and its subsidiaries were not registered companies at that time and the service contracts made were therefore declared to be void. It followed that the operating subsidiaries which were forced to pay out moneys pursuant to the service contracts had to be placed in "*statu quo*", as Judge CLARK pointed out (142 F. (2d) at p. 426). It was only the violation of the Act in the *Goldstein* case which made illegal the service contracts with the Bond and Share service companies. In that case the payments to the service companies were the direct consequence of the illegal act, and, thus, the illegal act caused the loss. In the case at bar, the lack of registration did not cause the loss, for had the company registered the result would have been the same. On the other hand, if the securities were held for the motives ascribed to the defendants in breach of their fiduciary duties this would have been illegal without reference to the Act.

Conclusion.

From the foregoing it must be apparent that the plaintiff has not alleged any cause of action which meets the jurisdictional requirement of Section 25 of the statute, that it shall be an action to enforce a liability or duty created by the Act. In so far as he may have alleged any cause

of action, it is one to enforce time-honored rules governing the conduct of corporate fiduciaries. In truth, plaintiff, by mentioning a Federal statute, attempts to obtain Federal jurisdiction, although the cause of action is not one to enforce that statute. Such attempts have been uniformly rejected. *Herrmann* v. *Edwards*, 238 U. S. 107 (1915); *Meyer* v. *Kansas City Southern Ry. Co.*, 84 F. (2d) 411 (C. C. A. 2, 1936), cert. denied, 299 U. S. 607 (1936). This is not a case where the courts are called upon to adjudicate the non-federal part of a claim once Federal jurisdiction as to part of the claim is established. This is a case in which no Federal claim is presented. It is not permissible to enlarge the jurisdiction defined in Section 25 of the Act. *Indianapolis* v. *Chase National Bank*, 314 U. S. 63, 76-7; *Thomson* v. *Gaskill*, 315 U. S. 442, 446.

The petition for a writ of certiorari to the Circuit Court of Appeals for the Third Circuit should be denied.

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